NAQVI | VAN NESS
ASSET MANAGEMENT, LLC

Applied Insights

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Feature Insight

Seeking Returns from Value

In the Long and Short models, we measure “Value” both “statistically” (Enterprise Value relative to Sales and Assets) and “fundamentally” (Free Cash flow to Enterprise Value (FCF)). Our long model emphasizes companies which are cheap on one or both of these measures. Our short model favors companies which are expensive and with negative free cash flow – among other factors.

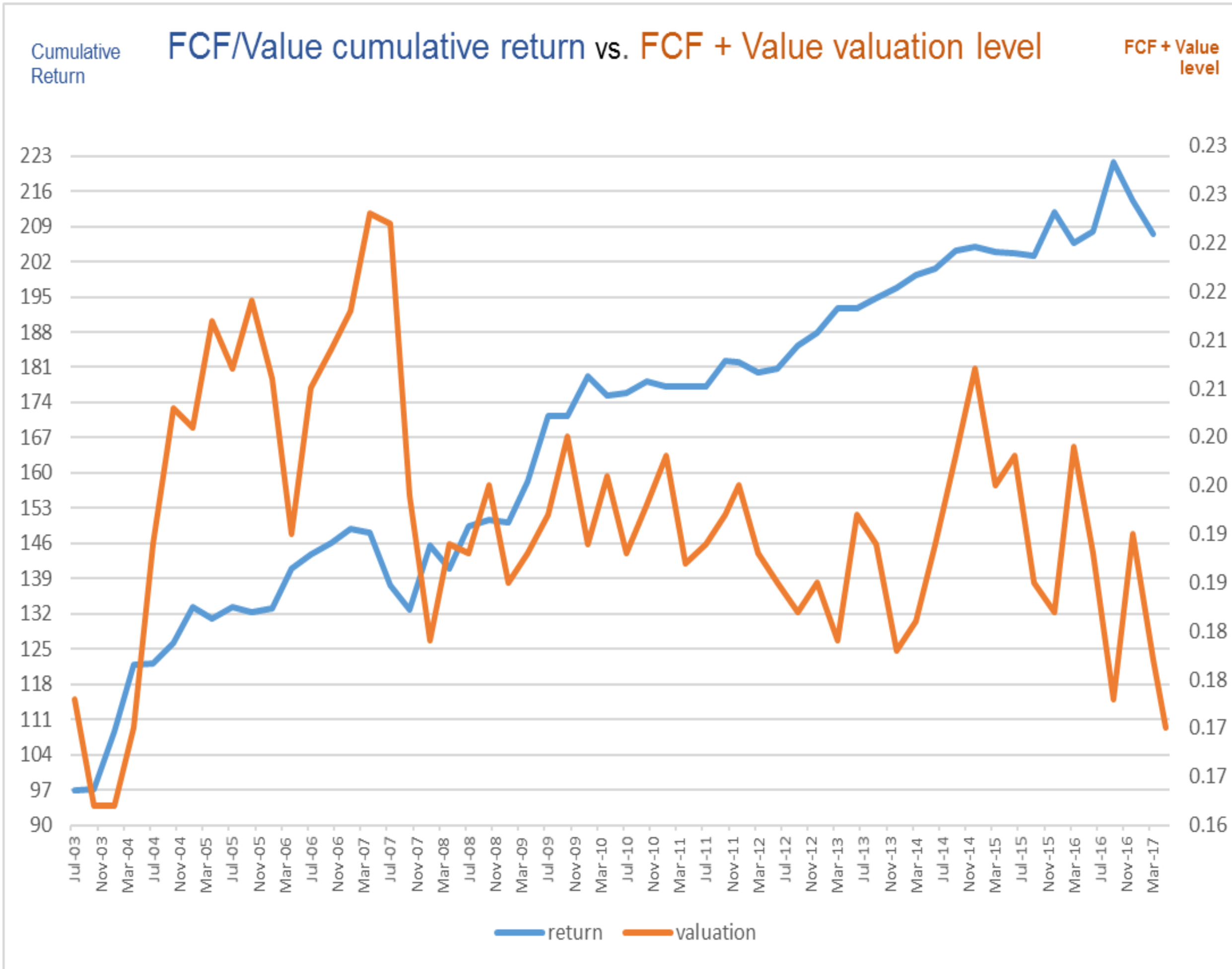
Both Value measures have performed exceptionally poorly. For example, the average historical six-month return of the top quintile of the statistical Value factor vs. the bottom quintile has averaged 4.1%. For the FCF factor, the spread has been 3.8%. For the first five months of 2017, these respective spreads were -11% and -15%. This was the worst period for Value in a decade while it was the worst period for FCF in our data going back to 2000. In plain English, investing in companies which appeared richly valued and which were generating poor or negative levels of free cash flow has been a rewarding strategy this year. Needless to say, such periods, while painful, are also relatively rare and, of course, unsustainable over time.

To put their “valuation” in historical perspective, we have made the following chart of the combined “Value of Value” and the “Value of FCF”. That is, how are the “cheap” companies being valued relative to “expensive” companies as compared to what historically has been normal. We plotted the cumulative average returns of these value and FCF factors against their valuation.

If you “eyeball” the graph, you can see that when” Value” has been relatively cheap (such as currently), solid returns from these factors have followed. More specifically, if we consider the historically similarly “cheap” readings (Best 10 beginning of quarter readings over the 2003-16 period), we find that the average subsequent combined alpha of these factors was 5.1% for the subsequent quarter versus the 1.9% overall average and -7.1% for the past two “quarters” (through May).

Thus, we conclude that “Value” is cheap and attractive.

We, of course, do not know when value will reassert to at least "normal" levels. But we know that no market environment is permanent and "change" is the one thing we can count on.


FCF/Value cumulative return vs. FCF + Value valuation level
Cumulative Return
FCF + Value level
223
216
209
202
195
188
181
174
167
160
153
146
139
132
125
118
111
104
97
90
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return
valuation